



Consultation paper on safeguarding clients' funds placed with stock brokers/ Clearing Members (CMs): Upstreaming of clients' funds to Clearing Corporations (CCs)

1. Objective

This consultation paper seeks comments from stakeholders on the enclosed SEBI proposal to further safeguard investor funds placed with their stock brokers and Clearing Members (CMs).

2. Summary of issue and proposal

- a. While several steps have been taken by SEBI over the years to safeguard investors' securities and funds, a significant amount of investor funds may still be vulnerable to the risk of potential misuse. As an illustration, on January 6th, the day of the last running account settlement, approximately INR 46,000 crores of investor funds was held with brokers and CMs. Anecdotal evidence suggests that the number may be even higher during other days. It may also be noted that India's 1355 stock brokers are not subject to all the regulatory safeguards that other client fund-accepting financial institutions are.
- b. SEBI has floated another consultation paper dated January 17, 2023, on "blocking of funds for trading in the secondary market". While that proposal, when implemented, should reduce some of the surplus investor funds with stock brokers, it may not completely eliminate such surpluses.
- c. The enclosed proposal seeks to mitigate this fund-related risk by mandating daily upstreaming of all investor funds from stock brokers and CMs to Clearing Corporations (CCs). Investor funds in surplus of exchange margin requirements (i.e. unutilized cash collateral) may in turn be placed by CCs in very low-risk and liquid overnight money market instruments. This proposal also envisages independent daily confirmation to investors around their daily funds position in the securities market ecosystem.



- d. While this proposal could reduce the float income implicitly enjoyed by brokers and CMs, the risk of fund misuse in the ecosystem should reduce substantially. In addition, investors will retain the flexibility to improve returns on their surplus funds using other duly authorized and suitable financial service providers.
- e. This consultation paper follows extensive discussions held by SEBI with multiple stakeholders, including with the stock exchanges, clearing corporations, and SEBI Intermediaries Advisory Committee (IAC) which comprises of representations from brokers and brokers Associations.

3. Current context and issue at hand

- I. Participation of retail investors in securities markets – both in numbers and in volume - has seen a significant rise in recent years. This puts a greater onus on SEBI to strengthen processes and ensure investor protection.
- II. From time to time, SEBI has provided guidelines for safeguarding clients' funds routed through stock brokers/ CMs. Vide SEBI circular dated July 20, 2021, as an example, stock brokers are required to disclose on a daily, client-wise and asset-wise basis, the amount of collateral received by them from each of their clients, the amount retained by them, and the amount passed on to a CC. Investors can access information pertaining to their funds from a web portal, developed by CCs, thus ensuring transparency and mitigating the risk of any misreporting by stock brokers. These provisions have come into force with effect from October 01, 2021.
- III. With effect from May 02, 2022, CCs must ensure that the collateral belonging to a client is used towards obligations of that client only, based on the information of client-wise breakup of collateral. Such identification / segregation of collateral is based on information provided by stock broker/ CM.
- IV. From time to time, SEBI has also provided guidelines on independent monitoring of clients' funds with stock brokers. Stock brokers are required to



upload data relating to their clients' funds on stock exchange platforms. Stock exchanges compare the total available funds with the stock broker and CC/ CM with clients' funds as per ledger balance. Any shortfall in funds is monitored and actioned by exchanges and highlighted to SEBI, albeit with a lag.

- V. Clients' funds arising from pay-out is required to be transferred by the broker to the client within 24 hours of such payout, unless the client has opted for a running account settlement. Under running account settlement, the funds in the client's account is required to be settled once in a quarter/ month, based on client's preference. Client has also the option to settle every settlement obligation separately.
- VI. As per the existing framework, posting of collateral and settlement of funds/ securities is carried out in the manner mentioned below:
 - I. Investors / clients post collateral with their stock broker before executing trades, and carry out settlement of funds/ securities through their stock broker on crystallisation of settlement obligations.
 - II. For their own proprietary trades as well as for trades of their clients, stock brokers post collateral with their CM and carry out settlement of funds / securities through their CM.
 - III. In turn, CMs post collateral with the CCs for their own proprietary trades and for trades of their constituents/ clients. At CC level, the portion of collateral blocked for margin purposes is marked as 'utilized collateral' and the balance funds in excess of required margin is marked as 'free collateral' or 'unutilized collateral' for respective clients.
 - IV. The existing framework allows for retention of certain portion of collateral at every level. Therefore, when a client / investor posts funds with a broker, a part of such funds can be retained by stock broker, and a part by the CM, before passing on the balance to CC.



- VII. Thus, client's funds (for margin and in excess of required margin) pass through the stock broker and CM before reaching CC, with the possibility of retention of some funds at each level. Similarly, the pay-out released by CC follows a similar cycle of passing through CM and stock broker before reaching the client.
- VIII. Such surplus client funds lying with stock brokers/ CM are still vulnerable to possible misappropriation. It may be noted that stock brokers are not subject to all the regulatory safeguards that other formal client fund accepting institutions are.
- IX. In a few cases of default by stock brokers, it has been observed that there was a shortfall of funds with defaulter stock broker to meet the obligation of clients.
- X. In order to protect investors' interests, it is imperative that the investors' funds should be adequately protected from possibility of misuse/ default by any intermediary.

4. Proposed Framework

A. Cash collateral allocation

- I. In the proposed framework, stock brokers shall place the entire clients' funds with the CM with segment wise, Unique Client Code (UCC) wise allocation of collateral. The CM would in turn place these funds with the CC, allocated against the concerned client. The client funds placed with CC shall be marked as cash collateral against the respective clients.
- II. The payment made by clients towards early pay-in for securities purchase transactions shall also be up-streamed to CCs on End of the day (EoD).
- III. Surplus funds received by stock brokers from clients are withdraw-able by clients on an immediate basis. Therefore, these should be deposited with the CC on "as is" basis rather than the broker converting them into a bank guarantee (BG)/ fixed



deposit receipts (FDRs) for placing with CC. Investor funds in surplus of exchange margin requirements may in turn be placed by CCs in very low-risk and liquid overnight money market instruments.

IV. Currently, CCs send SMS / email to the clients with regard to the allocation of cash collateral made by the stock brokers. The clients can also login to the website of the CC to view the segregation as well as allocation of the collateral on EoD basis. In the proposed framework, it is proposed that CCs shall make available the below mentioned information to respective clients on an online portal on CC websites and also by sending SMS & email on daily basis:

- a) Utilized collateral
- b) Unutilized collateral (i.e. surplus funds)
- c) Early pay-in funds

Note that under the proposed framework, the above balance confirmation would represent the sum total of all client funds in the securities ecosystem, ex-brokerage, since no client funds would be retained at the broker/ CM level.

B. Pay-in of funds by clients

- I. For pay-in obligations from clients, the brokers may transfer a portion of the respective client's unutilized collateral placed (i.e. surplus funds) with CC to meet the daily pay-in. In the event of insufficiency of unutilized collateral to meet the respective pay-in obligation, the client shall provide additional funds to stock broker and the same shall be placed with CC through CM. As before, each broker shall bear full responsibility for ensuring provision of adequate funds towards settlement obligations of their clients.
- II. The funds placed with CC for early pay-in shall be automatically used for pay-in at the time of settlement.



C. Pay-out of funds to clients

- I. Stock broker shall request for release of funds on daily basis (via CM) to meet the client funds pay-out requests / settlement of Bill-to-Bill clients / transfer to other CC etc. and any balance remaining end of the day towards client payables shall be placed back with CC on the same day to ensure that no client funds are retained by stock brokers.
- II. CMs would be able to place release request any time during the day till 6 PM. CCs shall check for releasable amount and release the funds to CM accounts within two hour of the request received from CM. The CM shall transfer the funds to broker.
- III. Broker shall ensure that any payout request by clients, made prior to 6 PM shall be honored within the same day. Pay-out requests made post 6 PM shall be honored on the next day.

D. Treatment of brokerage and other charges

- I. As per SEBI Circular SEBI/HO/MIRSD/MIRSD2/CIR/P/2016/95 dated September 26, 2016, the following has been prescribed:

"Transfer of funds from "Name of Stock Broker -Client Account" to "Name of Stock Broker -Proprietary Account" is permitted only for legitimate purposes, such as, recovery of brokerage, statutory dues, funds shortfall of debit balance clients which has been met by the stock broker, etc. For such transfer of funds, stock broker shall maintain daily reconciliation statement clearly indicating the amount of funds transferred. "

- II. Under the proposed framework, the stock broker shall perform client wise daily reconciliation, and deduct only the required respective brokerage and statutory



charges prior to upstreaming of clients' funds to CC at EoD. The contract note sent to clients shall mention all the relevant charges levied to the client.

E. Treatment of brokers providing 3-in-1 account facility

- I. Currently, some brokerage houses, with a tie-up with banks, provide 3-in-1 accounts facility for trading in securities market. A 3-in-1 account allows a client to hold securities (in a demat account), buy or sell them (through a trading account) as well as hold clients' own funds (in a bank account).
- II. Under 3-in-1 account facility, as and when a client places a buy order, funds get blocked to the extent of purchase value in the bank account of the client. If sufficient funds are not available in the linked bank account of the investor, the order cannot be confirmed. Likewise, in case of orders in derivatives segment, the necessary margin required is blocked in the client's bank account before the order/ trade is put through. In all these cases, the funds are retained in client's bank account, with a lien to the extent of client obligations marked in favour of the broker.
- III. The pay-in of funds blocked at the time of order placement is processed after-market hours. These funds then stay with the broker till the time of settlement and hence the possibility of misuse of client funds by stock broker persists.
- IV. In view of the above, it is proposed that there shall be no difference for 3-in-1 brokers and other brokers in terms of upstreaming of clients' funds to CC on EoD basis.

F. Compliance and monitoring of the proposed mechanism

- I. Stock brokers must ensure that all client funds are upstreamed to the CC by end of each day.



- II. Stock brokers will have limited and clearly designated bank accounts that are appropriately labelled. The accounts used for client flows, operations, proprietary trading etc. will be clearly demarcated and kept separate.
- III. Stock brokers will at all times provide updated details of all their bank accounts (i.e. bank account number and the appropriate account nomenclature) to stock exchanges and on their websites.
- IV. Stock exchanges shall obtain independent confirmation of all end-of-day broker account bank balances from banks.
- V. In turn, stock exchanges will verify that all client balances (net of brokerage and other legitimate charges) have been upstreamed to CCs. They will also check for any unauthorised movement of client funds to any other account of the broker.

G. Process flow

The comparative process flow vis-à-vis existing framework and proposed framework is explained as follow:

Sr. no.	Existing framework	Proposed framework
1.	Clients place funds for the purpose of collateral and/or pay-in obligation with the trading member.	No change.
2.	The stock broker in turn places these funds with the CM specifying the details of segment as well as uniquely identified client account.	No change, except that no client funds will be now retained at the broker level.
3.	While placing the funds with CM, the stock broker may create an FDR/ BG out	Clients' funds would need to be transferred to CM on an "as is" basis instead of undergoing a



	of clients' funds and place the same with CM.	tenor transformation to FDRs/ BGs.
4.	The CM further passes on these funds to CC. The CM also allocates these funds for collateral to the respective UCCs/ TM Pro/ CM Pro/CP Code etc.	No change, except that no client funds will now be retained at the CM level.
5.	The stock broker or CM may retain a portion of such funds with them.	To reiterate, any balance remaining end of the day with stock brokers/ CM (over and above of payables towards client) shall be placed back with CC on the same day to ensure that no client funds are retained by stock brokers/ CM.
6.	Stock brokers manage fund flow to ensure release of funds on daily basis to meet the client funds pay-out requests/ settlement of Bill-to-Bill clients / transfer to other CC etc. The balance remaining end of day with them are retained by members.	Stock broker shall request for release of funds to CM and CM shall request to CC for release of funds on daily basis to meet the funds pay-out requests / settlement of Bill-to-Bill clients / transfer to other CC etc. and any balance remaining end of the day with them towards client payables shall be placed back with CC on the same day to ensure that no client funds are retained by stock brokers/ CM. CMs would be able to place release request any time during



		the day till 6 PM. CCs shall check for releasable amount and release the funds to CM accounts within two hour of the request received from CM. The CM shall transfer the funds to stock broker, for onward transfer to the investor the same day.
7.	CM transfers funds to CC to meet its pay-in obligations as per timelines prescribed by CC.	CM may request CC to apportion the unallocated free funds to meet the daily pay-in requirements.
8.	Clients, at any time may request release of excess funds from the stock broker. The stock brokers shall honor these requests, as and when received.	No change.
9.	Treatment of brokerage and other charges: As per extant practice, the stock brokers can deduct the required due charges from client by way of transferring the same to the proprietary account. The stock broker shall maintain daily reconciliation statement clearly indicating the amount of funds transferred. The contract note sent to client shall mention all the relevant charges levied to the client.	The stock broker shall perform client wise daily reconciliation, and deduct the required respective brokerage and statutory charges prior to upstreaming of clients' funds to CC at EoD. The contract note sent to clients shall mention all the relevant charges levied to the client.

The proposed framework shall have no impact on Running Account Settlement obligations of stock brokers.

5. Public Comments

- 1) The public comments / suggestions may be provided in MS Excel file as per the following format:

Name of the person/entity			
Contact details			
Category	Whether market intermediary/ participant (mention type/category) or public (investor, academician etc.)		
Sr. no	Extract from consultation paper	Comments/ Suggestions	Rationale
1.	Do you visualize any operational challenges on the proposed concept, associated processes, transaction flow, risk management etc. If yes, please elaborate.		
2.	Could the proposed concept lead to increase in any risks? If yes, please elaborate.		
3.	Any other comments, relevant to the discussion topic (please mention the para no. and extract of the consultation paper)		

- 2) Kindly mention the subject of the communication as, "Comments on consultation paper on Safeguarding clients' funds placed with stock brokers".
- 3) Comments as per the above format may be sent latest by February 17, 2023, through the following modes:



- (i) Preferably by email to Ms. Aradhana Verma at aradhanad@sebi.gov.in and / or to Shri Ashutosh Parauha at ashutoshp@sebi.gov.in;
- (ii) By post to the following address:

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